Active Quantitative Equity

Value Investing Has Partially Recovered. Here's Where We See Value in Equity Markets Right Now.

- The rebound in value has been least pronounced in North America, in part due to the concentration of stocks (including FANG[1] stocks) in that region.
- Internet retailers, beverages, biotech, IT software and IT services continue to look relatively expensive according to our proprietary measures.

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Value investing – choosing stocks that are trading for less than their true economic value – is central to our investment approach, along with measures of quality and market sentiment. As we discussed in our July 2018 commentary, the value theme has yielded a distinct premium over time. Like other investment themes, value also experiences cyclicality. In July of last year, value was in the midst of a long, worldwide period of underperformance. Since then, value has partially recovered around the world, after experiencing a particularly acute decline during 2017 and much of 2018 (*see Figure*). This recovery in value is partially linked to the recent high-beta rally in equity markets – a phenomenon we'll unpack in greater detail in next month's commentary. In this month's commentary, we'll examine what's changed since value started to turn around in the second half of 2018 and discuss where we see value right now.

Figure: The value investment theme has partially recovered around the world after experiencing an acute decline.

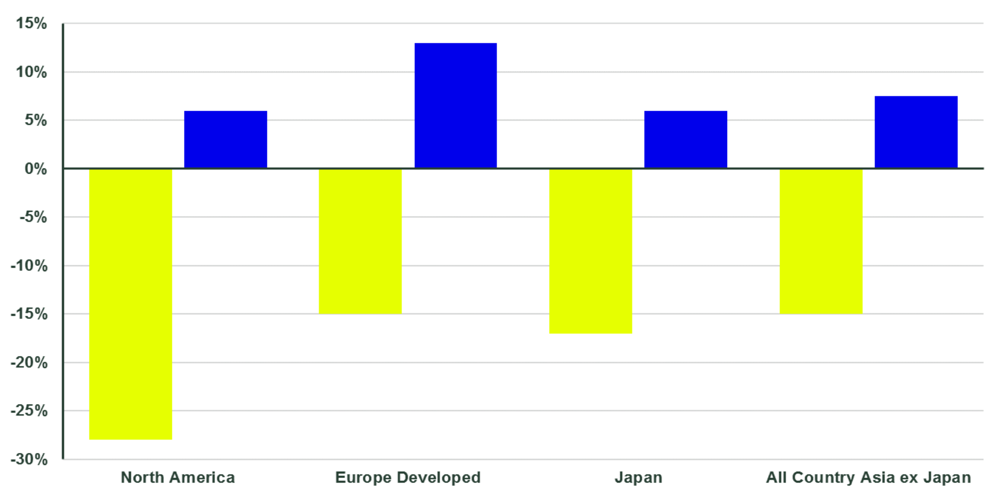

Figure:

Performance of SSGA proprietary value measure during periods December 2016 through August 2018, and August 2018 through February 2019.

Legend

December 2016 to August 2018

August 2018 to February 2019

Source: State Street Global Advisors, Worldscope, Factset, as of February 28, 2019 in USD. Based on a portfolio long the cheapest, equally weighted quintile and short the most expensive, equally weighted quintile in each geography, as drawn from the MSCI IMI Universe. State Street's proprietary value measure include a wide range of metrics applied using an industry-specific approach, including (but not limited to) price-to-book, price-to-earnings, price-to-sales and price-to-cash flow ratios, earnings before interest, taxes, depreciation and amortization, and dividend yield.

[1] The "FANG" acronym refers to Facebook, Amazon, Netflix and Alphabet's Google. More broadly, "FANG stocks" refer to high-growth consumer and technology stocks as represented in the NYSE FANG+ index.
[2] CFA® is a trademark of the CFA Institute

Value by Region

A review of the regional performance of our proprietary value measure reveals that value experienced the deepest decline and the weakest recovery in North America. Value has been relatively challenged in North America for two main reasons. First, North America contains the highest concentration of expensive companies (including FANG stocks) that continued to get more and more expensive in early 2018. This is where the underperformance of value was felt most acutely.

Second, cheap companies haven't performed very strongly over the past six months in North America. The best segments over the period for value in the region have been Consumer Services (8%), Utilities (8%), and Household and Personal Products (14%) – all reasonably expensive sectors. The worst have been Technology Hardware (-15%), Retailing (-11%), Energy (-10%)and Banks (-7%) – all on the cheaper side. Cheap stocks have recovered most compared to expensive stocks over the past six months in Europe. There, the expensive software segment has experienced a very large decline (-13%). Meanwhile insurance companies, where we see good value, have performed strongly (+3%), and Utilities (+8%) have been the strongest performing segment in Europe.

Value by Segment

When we consider value in Active Quantitative Equity, we look for measures that can be used to compare the price of thousands of companies to their fair value and to each other. We have a multi-dimensional view of value that incorporates dividends, cash flows, earnings, enterprise value, among other measures, depending on the industry.

Right now, we see good value in these segments:

- Airlines in North America and in Asia
- Road and Rail in North America and in Europe
- Auto Components in North America and in Europe
- Health Care Providers and Health Care Services in North America and in Japan
- Insurers in Europe
- Electric Utilities in Europe and in Asia
- Multi-utilities industry groups in Europe
- Banks in Asia

Across most regions, Internet retailers, beverages, biotech, IT software and services are the most expensive market segments.[3]

Although we believe that value is a crucial investment theme to consider, we also believe that value shouldn't be considered in isolation. In our view, it's important to examine quality characteristics, in part to understand whether a given cheap company is in fact cheap for a reason. Other measures can help reveal whether a company's stock – even if it's underpriced given its fundamentals – could suffer in the short term due to negative investor sentiment. With this in mind, we've also observed the following:

- There are some cheap large mining companies with reasonably good quality characteristics in Europe and Japan, but near-term sentiment according to our proprietary assessment is not attractive enough to warrant a large exposure.

- Many of the automobile companies are cheap, but their near-term sentiment is very poor, particularly in Europe and North America. Our proprietary analysis of their supply-chain networks also supports the view that these firms are cheap for a reason.

The Bottom Line

Investors who remained invested in value have recently reaped the benefits of their persistence as value bounced back in recent months. As a long period of underperformance in value continues to show signs of turning, we believe it's important to continue to seek undervalued companies of good quality, while keeping a close eye on short-term investor sentiment. In addition, we think that robust, nuanced and industry-specific measures of value, quality and sentiment, applied across all stocks in the investment universe, are essential to identifying the strongest opportunities.

Glossary

Value stock: A company with solid fundamentals (e.g., dividends, earnings and sales) that tends to trade at a lower price than its peers.

High-beta stocks (beta >1.0) are typically higher risk, but provide the potential for higher returns; **low-beta stocks** (beta <1.0) typically have less risk but also provide lower returns.

MSCI Investable Market Indexes. The MSCI Investable Market Indexes (IMI) cover all investable large-, mid- and small-cap securities across the Developed, Emerging and Frontier Markets, targeting approximately 99% of each market's free-float adjusted market capitalization.

3 Source: State Street Global Advisors, as of February 28, 2019. We base this observation on our proprietary, multi-dimensional value scores, and identify these groups as collectively the most expensive segments across three or more regions.

Marketing communication

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